Client Alert
November 3, 2017

Ways and Means Committee Releases "Tax Cuts and Jobs Act"

Introduction

On November 2, 2017, the Ways & Means ("W&M") Committee released draft legislative text of a tax reform bill, the Tax Cuts and Jobs Act. *(follow link to view full document, also posted at www.waysandmeans.house.gov)* W&M also released a section-by-section summary of the legislation and the Joint Committee on Taxation ("JCT") released estimates for the legislation *(also available at www.jct.gov, under publications)*. This is the start of a long legislative process towards enacting tax reform.

The W&M Committee released an updated draft (the "Chairman's mark") on Friday, November 3 (*see Amendment in the Nature of a Substitute to H.R. 1*) and W&M has scheduled a mark up of the legislation on Monday, November 6 at noon. Another revised draft, the "modified mark", will likely be released on Sunday evening or Monday morning. We expect additional offsets to be included in the mark and modified mark, and for W&M to mark the bill up beginning Monday at noon. The bill will likely change during the mark-up process. The goal is for W&M to finish the mark-up by the end of next week, and for the full House to take the bill up for consideration the following week (November 13). Although the full House typically votes only to accept or reject legislation, we expect House members will have an opportunity to offer additional amendments when the bill comes up for consideration before the full House. This will extend the voting process in the House, potentially making it difficult for the House to meet its goal of passing a tax reform bill by Thanksgiving.

The Senate is working on drafting its bill, and the timing for when the Senate will release its draft is unclear. A draft could be released as early as the week of November 13, although that date is likely to slip. Moreover, there are many areas of disagreement between the Senate and the House that will have to be resolved. These areas include: how to structure a limitation on interest deductibility, what the appropriate base erosion protection provisions are, and whether to allow immediate expensing (and, if so, for how long).

Below is a high-level summary of the W&M bill.

Individual Provisions

The bill consolidates the current seven tax brackets into four (12%, 25%, 35%, and 39.6%) and roughly doubles the standard deduction. The highest tax bracket would remain at 39.6% for high-income Americans, with that income tax bracket now starting at $1 million. The standard deduction is increased from $6,350 to $12,000 for individuals and $12,700 to $24,000 for married couples. In addition to the lower individual rates, small business owner would also receive a rate reduction (a maximum rate of 25%) on their business income.

In conjunction with the increase in the standard deduction, the bill eliminates many of the existing individual deductions and personal exemptions but preserves the child tax credit, earned income tax credit, charitable contribution deduction, and home-mortgage interest deduction (although changes have been made). The personal exemption for children and dependents would be consolidated into an expanded child tax credit and a new family tax credit. The bill increases the child credit to $1,600 from $1,000. It also adds a credit of $300 for each non-child dependent, although this credit expires after five years. The bill also eliminates most personal itemized deductions and credits, including deductions for student loan interest, medical expenses, and alimony payments. In particular, the bill repeals the state and local income tax deduction but preserves the deduction for property taxes up to $10,000. This change is highly controversial, and many Republican Representatives from high-tax states (such as California, New York, and New Jersey) are demanding additional changes that would allow their constituents to continue benefitting from the state and local tax deduction. These changes will be effective for tax years beginning in January 2018.

For debt incurred after November 2, 2017, the bill lowers the limit on the mortgage interest deduction from interest paid on $1,000,000 of mortgage indebtedness to interest paid on $500,000 of mortgage indebtedness. Existing home equity indebtedness is grandfathered. The bill also eliminates a taxpayer's ability to deduct mortgage interest paid on a second home, and permits interest to be deducted only on a taxpayer's principal residence. The bill also makes changes to a taxpayer's ability to roll over gain from the sale of the taxpayer's current home into the purchase of a new home tax-free: it phases-out the exclusion from gross income up to $500,000 for joint filers ($250,000 for other filers) of gain on the sale of a principal residence and also changes the "two of five" rule that excludes up to $250,000 ($500,000 for married taxpayers) in capital gains from the sale of a principal residence to "five of eight", meaning that a taxpayer would have to own and reside in the house for at least five of the last eight years to qualify for the exclusion. The rules also limit the use of the exclusion to one sale every five years (instead of one sale every two years). These changes will be effective for sales and exchanges after 2017.

The bill also streamlines higher education benefits. It would combine three separate tax credits for higher education expenses into one enhanced American Opportunity Tax Credit, and eliminate both the student loan interest deduction and tax-free tuition reimbursement from employers. These changes will be effective for tax years beginning after 2017.

The top capital gains rate remains unchanged at 20%. There are no changes to tax breaks for retirement accounts, including 401(k) plans and IRAs. The bill also preserves the Obamacare individual mandate.

Estate and Gift Taxes

The bill provides immediate relief from the estate tax by doubling the exclusion (from $5.49 million in 2017 to over $11.2 million as indexed for inflation), and then provides that the estate tax and generation-skipping tax will be eliminated after six years. However, the bill provides that, even after the estate tax is eliminated, beneficiaries will continue to receive a stepped-up basis in estate property. This provision is likely to be controversial, even among Republicans, and may change substantially during the course of the legislative process. Also beginning after six years, the gift tax exclusion is increased to double what the then estate tax exclusion would have been, the $11.2 million amount indexed for inflation, and the gift tax rate in excess of that threshold is lowered to 35% from current 40%. This provision may be more controversial than the estate tax provision.

Alternative Minimum Tax Repeal

The bill repeals the Alternative Minimum Tax (“AMT”) for both individuals and corporations. Taxpayers with AMT carryforwards will be able to claim a refund of 50% of remaining credits in tax years 2019, 2020, and 2021.

Business Provisions

The bill reduces the corporate income tax rate to 20%, beginning in 2018.

As expected, there is an immediate expensing provision for qualified property acquired and placed in service from 9/27/17 and 1/1/23. Eligible property includes property that is the taxpayer’s first use, instead of original property beginning with the taxpayer. Property used by regulated public utility companies and real property used in a trade or business are excluded. The taxpayer’s ability to elect to use AMT in lieu of additional depreciation is repealed.

There are two limitations on interest deductibility—see below for interest limitations in the international context. Generally, section 163(j) is repealed and a new provision provides that the interest deduction can’t exceed “business interest income” plus 30% of adjusted taxable income. “Business interest income” is defined as the amount of interest includible in a taxpayer’s gross income for the taxable year which is properly allocable to a trade or business. Investment income under section 163(d) is excluded from the definition. Adjusted taxable income is a taxpayer’s taxable income, without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (2) any business interest or business interest income, (3) net operating loss (“NOL”) deductions under section 172, or (4) depreciation, amortization, or depletion deduction. In addition, there is a 5-year carryforward for disallowed section 163(j) deductions on a first-in, first-out basis. This provision would apply to both domestic and foreign based companies.

As expected, section 199 is repealed in full. NOL carrybacks are repealed, except for certain disaster losses. For carryforwards, NOL deductions would be limited to 90% of taxable income.

Several business credits are also repealed, including the Work Opportunity Tax Credit and the Orphan Drug Tax Credit. Further, credits for expenses incurred to rehabilitate old and/or historic buildings would be repealed following a transitionary period.

Compensation provisions

The bill contains significant and sweeping changes to the taxation of executive compensation and employee benefits. For a description of these proposed changes, see alert issued by our Compensation and Employee Benefits group, ***Proposed Tax Reform Bill Puts Compensation & Benefits in the Crosshairs***, distributed on November 3, 2017.

Pass-through provisions

Business Income Tax

For pass-through businesses, the bill establishes a tax rate of 25% applicable to the portion of pass-through income classified as “business income”. Income not classified as “business income” is taxable at ordinary income rates. Passive investors in pass-through businesses are eligible to treat 100% of their income as business income, while non-passive owners and shareholders are subject to a formula test as to what is business income but may make a simplifying election to treat income as 30% business income and 70% ordinary income. Whether an interest is passive or non-passive is determined under the section 469 passive activity rules.

An interest holder in a professional service businesses will be deemed to have 0% business income, and therefore all income will be treated ordinary income.

Technical Terminations (Section 708(b)(1)(B))

The bill eliminates the “technical termination” regime applicable to partnerships, which gave rise to a new partnership for tax purposes if partners sold or exchanged more than 50% of their interests in partnership capital and profit during a 12-month period. Technical terminations under current law result in both taxpayer detriment in terms of restarting depreciation lives and potential taxpayer benefit in allowing taxpayers to make new tax elections.

Contributions to Capital (Section 118)

The bill eliminates the ability of corporations to exclude contributions to capital (such as local government incentives) from their taxable income. The repeal also extends the rule to non-corporate entities. In each instance, the requirement to include in income is disabled if the contributor receives stock of equal value to the contributed capital.

Energy Provisions

Production Tax Credit (Section 45)

The Production Tax Credit (“PTC”) is a credit computed annually in accordance with electricity production (1.5 cents tax credit per KwH) from certain renewable resources. In addition, there is available a PTC arising from the sale of refined coal from facilities that were placed in service prior to 2012. Each PTC is indexed for inflation. The bill repeals, effective November 2, 2017, the inflation adjustment factors for both renewable resources and refined coal. Accordingly, the PTC will equal the base amount of the credit under the existing statute.

Energy Investment Tax Credit (Section 48)

The Investment Tax Credit (“ITC”) equals 30 % of the eligible basis of certain assets that generate electricity from renewable resources. This amount is phased out for property the construction of which begins after 2022. Under the statute, the technologies are subject to varying start-of-construction dates for purposes of determining the ITC percentage.

The bill eliminates the varying start-of-construction dates so that all technologies are eligible for the ITC, and subject to the phase down, at the same rate. The bill also repeals the permanent 10 % ITC for property the construction of which begins after 2027.

Residential Energy Efficient Property (Section 25D)

The bill extends the amount of time that taxpayers have to place in service, and receive a tax credit for, qualified solar electricity and water heating property, and certain other energy assets. Specifically, taxpayers are eligible for a 30 % credit for property placed in service prior to 2020, which phases down to 22 % beginning in 2021.

Enhanced Oil Recovery and Production of Oil and Gas from Marginal Wells (Sections 43 and 45I)

The bill repeals these credits for tax years after 2017.

International Provisions

As expected, the bill contains a deemed repatriation provision and transitions to a territorial tax system. The deemed repatriation would be assessed at a bifurcated rate (12% for cash and cash equivalents, and 5% for non-cash assets). Taxpayers may elect to pay the liability in installments over an eight-year period. Earnings & Profits (“E&P”) is measured as of November 2, 2017 or <u>December 31, 2017</u>, whichever is higher. The bill provides a mechanism for aggregating all E&P deficits and allocating those deficits to Controlled Foreign Corporations (“CFCs”) with deferred E&P, reducing Subpart F income. There’s also an anti-abuse rule—the Secretary has discretion to disregard any transaction where the principal purpose of the transaction was to reduce the aggregate foreign cash position taken into account in determining the amount subject to repatriation.

Going forward, the bill provides for a 100% exemption for dividends paid by foreign corporations to US corporate shareholders that own 10% or more of the foreign corporation. The exemption applies for distributions made after 2017, no Foreign Tax Credits (“FTCs”) will be allowed for foreign taxes and no deductions for expenses allocable to an exempt dividend will be taken into account in determining the US corporate shareholder’s foreign-source income. There’s a minimum holding period to qualify for the exemption and dividends covered by the dividends received deduction will reduce (but not below zero) the US shareholder’s basis in its foreign stock. FTCs will be allowed for any subpart F income included in a US shareholder’s income on a current year basis, without regard to pools of foreign earnings kept abroad.

In addition, subpart F will be retained, although changes will be made to it—for example, section 954(c)(6) is made permanent and the 30-day requirement for CFCs is repealed. Incorporation of a foreign loss branch triggers a current inclusion in income and recapture of losses taken by the US corporation. Treasury will issue regulations providing for a basis adjustment in the share of the foreign corporation to reflect the gain recognized.

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Section 4301 is aimed at US corporations that have transferred their intellectual property ("IP") to low- or no-tax jurisdictions. It provides that a US parent of one or more foreign subsidiaries will be subject to current US tax on 50% of the US parent's "foreign high returns" (the excess of the foreign subsidiaries' aggregate net income over a routine return (7% + Applicable Federal Rate ("AFR")) on the foreign subsidiaries' aggregated adjusted bases in depreciable tangible property, adjusted downward for interest expense). There are several exclusions from "foreign high returns," including effectively connected income ("ECI") and subpart F income. The US parent will be taxed on its foreign high returns each year (regardless of whether the earnings are repatriated to the US or remain offshore). FTCs will be limited to 80% of foreign taxes paid, will not be allowed against US tax imposed on other foreign-source income, and can't be carried back or carried forward.

Section 4302 imposes a limitation on interest deductibility: The limitation applies to a US corporation that is a member of an international financial reporting group, and deductible interest is limited to the extent that the US corporation's share of the group's global net interest expense exceeds 110% of the US corporation's share of the group's global Earnings before interest, tax, depreciation and amortization ("EBITDA"). This limitation applies to both US-based and foreign-based companies, and applies in addition to the general disallowance for interest expenses under section 3301 (so taxpayers are disallowed interest deductions pursuant to whichever provision would deny a greater amount of deductions). There is a five-year carryforward for disallowed interest expenses, but no carryback. We expect the appropriate treatment of interest to be one of the key areas of discussion between the House and the Senate.

Section 4303 imposes a 20% excise tax on payments (other than interest) made by a US person to a related foreign corporation for payments that are deductible, included in cost of goods sold ("COGS"), or added to the basis of a depreciable asset, unless the foreign payee elects to treat those payments as effectively connected to a US trade or business. (Some are referring to this as the "super Divereted Profits Tax ("DPT")" provision.) There are exceptions for certain commodities transactions or intercompany services where the US pays cost. This provision applies to both US- and foreign-based companies. Based on the section-by-section summary, this appears to be one of the larger revenue raisers—it's projected to raise $154.5 billion over 10 years. There are several questions here, including whether this is a backdoor attempt to include the border adjustment tax (as described in the House Republican Blueprint for tax reform) in the House bill and how our treaty partners would view this provision. Alternatively, this provision could be viewed as Professor Brett Wells' base protecting surtax, as it imposes a surtax on all deductible outbound payments to related parties. However, this is one of the areas where there could be disagreement between the House and the Senate, and we expect this provision to be stridently debated.

The bill also limits treaty benefits for payments of Fixed, Determinable, Annual or Periodic ("FDAP") income that are deductible in the US and made by an entity controlled by a foreign parent to another entity in a tax treaty jurisdiction that is controlled by the same foreign parent. Under the bill, there's no treaty relief for the payment unless there would be treaty relief if the payment were made directly to the foreign parent.

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Tax Exempt Organizations

The bill makes significant changes to the unrelated business income tax ("UBIT"). It expands UBIT to all entities exempt from tax under section 501(a). It would exclude income generated by a tax-exempt organization's research activities from UBIT, but only if the results are freely made available to the public. These provisions would be effective for tax years beginning after 2017.

The bill reduces the excise tax rate on the net investment income of tax-exempt private foundations and certain charitable trusts from 2% to 1.4%, and subjects certain private colleges and universities to the 1.4% excise tax on their net investment income. The bill repeals the current rules providing for a reduction in the excise tax rate from 2% to 1% for private foundations that meet certain distribution requirements. In addition, donor-advised funds would be required to annually disclose their policies on inactive donor advised funds and the average amount of grants made from their donor advised funds. These provisions would be effective for tax years beginning after 2017.

The bill also exempts private foundations from the excess business holding tax if they own a for-profit business under certain conditions. Under current law, a tax-exempt private foundation may not own more than a 20% interest in a for-profit business, or an excise tax up to 200% will be imposed based on the value of that excess holding. Under the bill, private foundations are exempt from this excess business holding tax if (1) the foundation owns all of the for-profit business' voting stock; (2) it acquired all of its interests in the for-profit business other than by purchasing it; (3) the for-profit business distributes all of its net operating income annually to the private foundation within 120 days of the close of a tax year, and (4) the for-profit business' directors and executives are not substantial contributors to the private foundation and do not make up a majority of the foundation's board of directors. These provision would be effective for tax years beginning after 2017.

Finally, the bill effectively repeals the "Johnson amendment" and allows religious organizations to make statements relating to political campaigns without jeopardizing their tax-exempt status if the speech is in the ordinary course of the organization's business and its expenses are de minimis. This provision would be effective for tax years ending after date of enactment.